

ADMINISTRATIVE COSTS FOR MEDICARE ADVANTAGE PLANS CONTINUE MODERATING TREND IN 2010

Summary

Administrative expenses, per member, grew by 0.9% in 2010 compared with a decline of 4.1% in 2009. After adjusting to eliminate the effects of changes in product mix, per member costs declined by 3.9% similar to the 4.1% decline in 2009. Provider and Medical Management posted a sharp decline in as-reported per member growth rate with a *decline* of 1.3% compared with growth of 8.8% in 2009. The growth rate for the cluster of Corporate Services also declined, while offset by the Sales and Marketing and Account and Membership Administration clusters.

For the universe of Medicare plans submitting 2010 data, administrative expenses comprised 8.1% of premium equivalents, compared with 9.0% for plans submitting data in 2009. Administrative expenses of Medicare Advantage also comprised 8.1% of premiums in 2010.

The administrative expenses of comprehensive products for Medicare plans participating in our performance benchmarking study was \$44.73 PMPM, but varied greatly by product. Medicare SNP expenses had a median value of \$162.65 PMPM while the commercial ASO costs were \$20.62 PMPM. Medicare Advantage administrative expenses were \$81.61 PMPM.

In 2010, the commercial ASO administrative expenses were 6.1% of premium equivalents, the lowest ratio for comprehensive products in this universe. Medicare Advantage's administrative expenses were 8.1% of premiums, Medicare SNP was at 11.4% of premiums and Medicare PFFS was at 9.3% of premiums.

All values in this article *exclude* investment and non-operating income and expense, income taxes and miscellaneous business taxes. Pharmacy and Mental Health administrative costs are *included* in the Account and Membership Administration cluster. These results are excerpted from the Medicare edition of the 2011 *Sherlock Expense Evaluation Report*, comprising 2010 data.

Background on Medicare

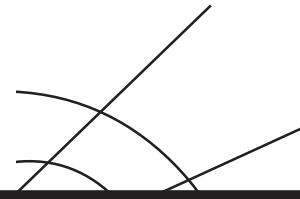
According to the Kaiser Family Foundation (KFF), Medicare covers approximately 48 million people with 25%, or 11.9 million, enrolled in a Medicare Advantage plan in 2011. In comparison, there were 11.1 million Medicare Advantage enrollees in 2010, or approximately 7% growth. Last year, the Medicare Advantage share was 24%. Enrollment in Medicare Advantage plans has more than doubled since 2004 and has increased in forty-four states comparing March 2011 with March 2010. The average premiums paid by beneficiaries has also declined by about \$5 per month in 2011 compared to 2010. The drop in average beneficiary premiums is the result of "aggressive premium setting by firms seeking to retain enrollees and attract new ones..." according to the KFF. The Centers for Medicare and Medicaid Services (CMS) believes that a similar trend will continue for 2012, that the average premium paid by Medicare Advantage beneficiaries will be, on average, 4% lower. CMS also projected that enrollment will increase by 10% during 2012.

In accordance with the Patient Protection and Affordable Care Act (ACA), payments made to Medicare Advantage plans from the government will be reduced over time to approach levels equal to regular Medicare program. This impact, however, will be muted for some plans that earn bonus payments based on the CMS Medicare Star Quality Ratings System. Medicare Advantage plans will face additional pressure beginning in 2014 when they will be subject to an 85% minimum "medical loss ratio," a variance from which will trigger

Figure 1. Medicare Advantage Benchmark Summary
Medicare-Oriented Costs by Functional Area Cluster, 2010 Data
Per Member Per Month

	25th PCTL	75th PCTL	Median	σ/ Mean
Sales and Marketing	\$8.41	\$25.47	\$14.63	55.7%
Provider & Med. Mgmt.	5.49	13.36	7.60	53.3%
Account & Mem. Admin.	9.08	26.63	12.67	66.8%
Corporate Services	5.65	12.78	10.25	66.5%
Total	\$32.21	\$86.36	\$44.73	54.7%

*Account & Membership Administration Includes Pharmacy and Mental Health



rebates to consumers. The MLR-rebate provision is specifically designed to encourage more efficient operations and lower administrative expenses.

Membership Trends and Mix Changes

Of the ten plans participating in our benchmarking study this year, six also participated in 2010. These continuing plans grew more rapidly in their Medicare products than the overall Medicare Advantage (MA) program, with 9.8% membership growth, on average. This is an increase from last year in which continuous participants experienced growth of 7.2%.

Collectively, the Medicare-focused plans served 1.0 million Medicare beneficiaries on average during 2010. Our Medicare benchmarks also include, in a separate exhibit, the MA cost attributes of plans offering, but not focused on, MA. These Blue Cross Blue Shield and Independent / Provider-Sponsored Plans served 1.0 million and 0.2 million members, respectively. In all, SEER reports on a total of 2.2 million Medicare Advantage beneficiaries, or approximately 18% of the total in the Medicare Advantage program.

For plans included in the core benchmarks, Medicare products comprised a mean value of 67.2% of premiums and fees and median value of 57.3%. Commercial comprised a mean of 32.5% and a median of 32.1% of premium equivalents.

Administrative Costs and Trends

For convenience of analysis, we group various functional areas into clusters and standardize for size by expressing expenses on a per member basis. Values for 2010 and rates of change for these clusters and overall are shown in Figures 1 and 2. Appendix A provides values for all plans participating in the 2010 benchmarking study and includes 2009 data.

Costs comparisons are based on the results for plans that participated in each of the comparison years. PMPM and percent values are for all plans that reported this year. We employed median values

throughout this process as the best measure of central tendency.

Sales and Marketing expenses were \$14.63 PMPM and decline by 5.1% compared with a decline of 8.6% in 2009. (All rates of change hold constant the universe of participants.) Holding these plans' product mix constant, Sales and Marketing expenses declined by 5.2% PMPM compared with a decline of 10.4% in 2009. At the 25th percentile, Sales and Marketing costs were \$8.41 and at the 75th percentile were \$25.47 PMPM.

Rating and Underwriting declined at double-digit rates on an as-reported and constant-mix basis. This function's decline in per member costs was the greatest of all functions for this cluster, using either as-reported or constant-mix convention. Advertising and Promotion and Product Development / Market Research also declined by double digits rates under both reporting conventions. By contrast, Sales and Marketing grew somewhat on an as-reported and constant-mix basis. Commissions declined on an as-reported basis but grew on a constant-mix basis.

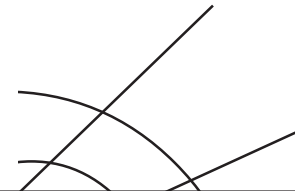
Figure 2. Medicare Advantage Benchmark Summary
Medicare-Oriented Percent Change in Costs by Functional Area Cluster

	2009 Data		2010 Data	
	Percent Change	Percent Change, Mix-Adjusted	Percent Change	Percent Change, Mix-Adjusted
Sales and Marketing	-8.6%	-10.4%	-5.1%	-5.2%
Provider & Med. Mgmt.	8.8%	8.8%	-1.3%	-5.4%
Account & Mem. Admin.	3.0%	1.7%	7.7%	5.4%
Corporate Services	1.1%	-4.1%	-2.8%	-6.7%
Total	-4.1%	-4.1%	0.9%	-3.9%

*Account & Membership Administration Includes Pharmacy and Mental Health

Medical and Provider Management declined by 1.3% (compared with an increase of 8.8% last year) to \$7.60 PMPM. The Provider Network Management and Services functional was entirely responsible for the decline in this cluster on an as-reported basis and two thirds of the decline on a constant-mix basis. Per member costs for the Medical Management / Quality Assurance / Wellness grew on an as-reported basis but declined slightly on a constant-mix basis. The costs of Medical and Provider Management at the 25th percentile was \$5.49 PMPM and \$13.36 PMPM at the 75th percentile.

Account and Membership Administration expenses increased to \$12.67, up 7.7% from last year. On a



constant-mix basis, growth accelerated from 1.7%, last year, to 5.4% in 2010. The value at the 25th percentile was \$9.08 PMPM, while the costs at the 75th percentile were \$26.63 PMPM.

Information Systems costs increased at double-digit rates and comprised the overwhelming proportion of the increase in this cluster of expenses, regardless of how costs are calculated.

By contrast, Claim and Encounter Capture and Adjudication costs increased marginally on both a constant-mix and as-reported basis. Enrollment / Membership / Billing costs declined in 2010 by double-digit rates on an as-reported and mix-adjusted basis, while Customer Services fell at single-digit rates by both methods of reporting.

Corporate Services costs decreased by 2.8%, compared with an increase of 1.1% in 2009 on an as-reported basis. On a constant-mix basis, costs decreased by 6.7%, compared with a decline of 4.1% in 2009. The costs in this cluster include such support areas as Finance and Accounting, Actuarial, Corporate Services (e.g., Facilities, Legal, Printing and Mailroom and OPEB), Corporate Executive & Governance and Association Dues and License / Filing Fees.

The Corporate Services *function* (as opposed to the cluster) fell at low single-digit rates on an as-reported basis and high single-digit rates on a constant-mix basis. This was slightly offset by Corporate Executive & Governance, which increased at mid double-digit rates for both on an as-reported and mix-adjusted basis. The cost of consulting activities are found here so it is possible that this surge reflects the need to adapt to the changes associated with health care reform. The Corporate Executive & Governance and Corporate Services functions dominate this cluster and largely explain its trend.

Finance and Accounting and Actuarial declined at double-digit rates, both as-reported and constant-mix. Association Dues and License / Filing Fees declined at single-digit rates on an as-reported basis and low double-digit rates for constant-mix. The expenses levels with Association Dues and License / Filing Fees are very small and accordingly have a modest impact on overall trend.

Total costs for this cluster was \$10.25 PMPM in 2010, while the 25th percentile

value was \$5.65 PMPM and the value at the 75th percentile was \$12.78 PMPM.

Expressing Costs as a Percent of Premium Equivalents

Notwithstanding its important drawbacks, health plans and others often express administrative costs as a percent of premiums. Indeed, the MLR rules under PFACA employ this as a driver for rebates paid to customers.

As shown in Figure 3, administrative expenses were 8.1% of premium equivalents for comprehensive products sold by Medicare plans. The 25th percentile value was 7.6% and the value at the 75th percentile was 10.7%. Comparing these results to those in Appendix B, administrative expenses were 93 basis points lower as a percent of premium equivalents. As discussed below, each cluster of expenses declined relative to premiums.

Sales and Marketing costs comprised 2.7% of premium equivalents, with the 25th percentile value at 2.4% and the value at the 75th percentile at 3.3%. The comparable median percent was 3.1% or 36 basis points lower than for 2009.

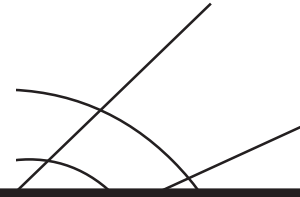
The value at the 25th percentile for Provider and Medical Management was 1.5% of premium equivalents, while the 1.8% of premium equivalents represented the 75th percentile. The median value, at 1.5% was 5 basis points lower than the 1.6% posted last year. (Rounding affected these numbers.)

The cost of Account and Membership Administration was 2.7% of premium equivalents, a slight decline of 11 basis points from last year's reported median of 2.8%. The value at the 25th percentile was 2.1% of

Figure 3. Medicare Advantage Benchmark Summary
Medicare-Oriented Costs by Functional Area Cluster,
as a Percent Premiums or Equivalents, 2010 Data
Percent of Premium Equivalents

	25th PCTL	75th PCTL	Median	σ/ Mean
Sales and Marketing	2.4%	3.3%	2.7%	29.7%
Provider & Med. Mgmt.	1.3%	1.8%	1.5%	19.6%
Account & Mem. Admin.	2.1%	3.0%	2.7%	33.8%
Corporate Services	1.1%	2.3%	1.6%	41.4%
Total	7.6%	10.7%	8.1%	21.5%

**Account & Membership Administration Includes Pharmacy and Mental Health*



premium equivalents and 3.0% of premium equivalents at the 75th percentile.

The median proportion of premium equivalents due to Corporate Services was 1.6%, 37 basis points lower than last year's value of 2.0%. Twenty-five percent of plans had values below 1.1% of premium equivalents and twenty-five percent of plans had values above 2.3% of premium equivalents in 2010.

Administrative Expenses by Product

All participants in our benchmarking studies segment their costs by product as well as by over forty functional areas. Overall, the resources consumed in these products are reflected in varying administrative expenses that differ quite sharply between the various products. Our participants normally have cost allocation methodologies to facilitate this, including sometimes quite robust activity-based costing systems, so that costs are not normally allocated by member.

For example, suppose commercial HMO members have, on average, 40% of the number of annual claims as members in Medicare Advantage products. Commercial products' per member claims adjudication expenses will be correspondingly lower as well. Similarly, ASO products have lower overall costs than their insured counterparts since ASO arrangements are normally provided only to larger groups that tend to require fewer marketing resources per group.

These differences are manifest in their overall cost differences. The most expensive product offered by Medicare plans is their Medicare SNP product at \$162.65 PMPM. Medicare Advantage and PFFS followed at \$81.61 and \$78.84, respectively. The least expensive comprehensive product offered by these health plans was the ASO product at \$20.62 PMPM. This is shown in Figure 4. The stand-alone Medicare Part D was lower still, at \$12.41 PMPM.

As shown in Figure 5, the ranking of administrative expenses by product is different on a percent of premium basis. The ASO product remained among the lowest cost on a percent basis, at 6.1% of premium equivalents, but it was followed by Medicaid and Medicare Advantage at 6.8% and 8.1%, respectively. The high cost products, calculated based on a percent of premium equivalents, were Indemnity and PPO Insured at 12.0% and Commercial POS Insured at 13.0%. Meanwhile, Medicare SNP was 11.4% of premium equivalents.

Calculation of Premium Equivalents

Administrative services relationships comprise a relatively small part of the business mix of Medicare Advantage plans. On average, they comprise only 9.7% of members and most plans in our survey do not serve this market at all. Nevertheless, to the extent such relationships exist, they play havoc with the intuition that administrative costs, when expressed as a percent, are a proportion of the premium dollar. That is because, under ASO relationships, employers are only billed for the administrative services that they provide rather than for the cost of care, which is borne by the self-insured groups.

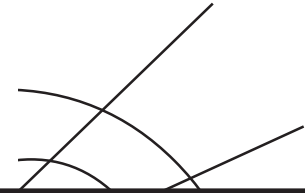
Our solution to this is to express expenses as a percent of premium equivalents. Since each of the plans submits the health care expenses for the self-insured groups (which they know since they process their self-insured claims), by adding this amount to the administrative service fees actually billed, we are able to estimate the premium equivalents of the ASO arrangements.

Note that, as with premiums, fees charged to ASO clients reflect a profit assumption. Therefore, to estimate premium equivalents it is appropriate to add the fees rather than the administrative expenses to directly compare costs with the insured business.

Calculation of Constant-Mix Rates of Expense Growth

To make the most useful comparisons of administrative expenses between years, it is illuminating to eliminate the effects of product mix differences. This is beneficial both between organizations with different product mixes and also between periods. Accordingly, in comparing expenses between periods, we hold constant the product mix between the two years.

To do this, since Medicare Advantage plans report to us by product, we reweight their expenses so that the product mix existing in the prior period is the same as in the current one. We then recalculate the constant-mix rates of change based on these reweighted estimates.



Comparisons Across Universes

Health plans in other Sherlock Company benchmark universes also offer Medicare products. Figure 6 compares them. Note that the ranking varies depending on whether percents or PMPM costs are used. While Medicare plans have the highest PMPM costs, they have the lowest costs on a percent of premium basis. IPS plans are lower than their Blue counterparts offering this product by both metrics.

The firms offering Medicare Advantage operate somewhat differently, as discussed below.

Sales and Marketing: Medicare-focused plans have higher Sales and Marketing costs than do IPS plans and much higher than Blue plans. Blue plans are far more heavily reliant on external brokers, reflected by higher commissions, than Medicare-focused plans and somewhat higher than IPS plans. Medicare universe reliance on their internal sales forces is illustrated through their very high internal Sales and Marketing function (as opposed to the cluster), twice as high as found in either IPS or Blue universes. Advertising and promotion is high for Medicare plans closely followed by IPS, then more distantly by the Blues. Rating and Underwriting (which contains the HCC costs) is highest for the Medicare-focused plans with the IPS plans closely following, and with Blues a distant third.

Provider and Medical Management: Medicare plans have considerably higher costs in this cluster than their Blue or IPS peers. Medical Management costs are the dominant costs in this function and they are much higher for the Medicare universe, followed by Blue and IPS plans. The IPS plans had the highest Provider Network Management and Services costs, followed by Medicare and Blue plans.

Account and Membership Administration: Blues had the highest costs in this expense cluster by a wide margin over the IPS and Medicare plans. In order of importance, Blue plans had higher costs than their peers due to Information Systems, Claims and Enrollment. Medicare plans had higher costs com-

Figure 4. Medicare Advantage Benchmark Summary

Medicare-Oriented Costs by Product, 2010 Data

Per Member Per Month

	25th PCTL	75th PCTL	Median	σ/ Mean
HMO	\$28.87	\$37.64	\$29.91	31.4%
POS	34.12	51.17	41.95	37.9%
Indemnity & PPO	28.13	43.29	34.29	28.1%
Total Comm. Ins.	\$28.33	\$40.84	\$31.87	25.3%
ASO	12.61	26.34	20.62	43.5%
Total Commercial	\$25.14	\$28.82	\$28.71	14.6%
Medicare Advantage	67.72	96.61	81.61	28.5%
Medicare Advantage PFFS	78.84	78.84	78.84	NM
Medicare SNP	138.55	186.75	162.65	41.9%
Medicare Total	\$68.11	\$95.86	\$85.29	21.3%
Medicaid	13.78	20.23	14.72	39.2%
Comprehensive Total	\$32.21	\$86.36	\$44.73	54.7%
Medicare Part D	\$9.98	\$16.62	\$12.41	49.4%

Figure 5. Medicare Advantage Benchmark Summary

Medicare-Oriented Costs by Product, 2010 Data

Percent of Premium Equivalents

	25th PCTL	75th PCTL	Median	σ/ Mean
HMO	8.4%	11.8%	9.4%	28.0%
POS	8.1%	13.0%	13.0%	39.6%
Indemnity & PPO	8.7%	14.5%	12.0%	45.9%
Total Comm. Ins.	8.3%	13.5%	10.1%	34.7%
ASO	3.9%	8.0%	6.1%	44.5%
Total Commercial	8.1%	9.5%	8.8%	23.3%
Medicare Advantage	7.0%	10.5%	8.1%	29.3%
Medicare Advantage PFFS	9.3%	9.3%	9.3%	NM
Medicare SNP	9.5%	13.3%	11.4%	46.5%
Medicare Total	7.1%	10.6%	8.1%	24.3%
Medicaid	6.8%	7.3%	6.8%	9.1%
Comprehensive Total	7.6%	10.7%	8.1%	21.5%
Medicare Part D	6.5%	9.0%	7.1%	32.7%

pared with their IPS counterparts because Medicare plans had higher Information Systems costs and Customer Services costs.

Corporate Services: Medicare focused plans and Blue plans had similar expense levels in this cluster, while IPS plans were significantly lower. The Medicare plans had the highest expenses in the Finance and Accounting and Corporate Executive and Governance areas. These functions are not only among the few that are scalable but are also especially susceptible to cost increases associated with adaptation to the PPACA.



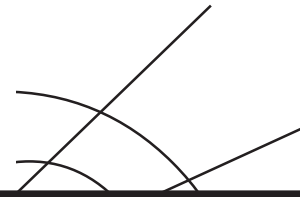


Figure 6. Medicare Advantage Benchmark Summary
 Medicare-Oriented Characteristics by Universe, 2010 Data

	Medicare	Independent / Provider- Sponsored	BCBS	Combined Universes*
Administrative Expenses PMPM				
25th PCTL	\$67.72	\$58.55	\$67.21	\$65.59
Median	81.61	66.03	74.31	74.15
75th PCTL	\$96.61	\$75.20	\$84.29	\$92.85
σ/ Mean	28.5%	34.1%	18.0%	25.1%
Administrative Expenses as a Percent of Premiums				
25th PCTL	7.0%	7.3%	6.8%	7.0%
Median	8.1%	8.3%	8.4%	8.4%
75th PCTL	10.5%	9.6%	10.0%	10.1%
σ/ Mean	29.3%	16.6%	24.7%	24.6%
Plans Offering Medicare Advantage	10	6	15	31
Medicare Comprehensive Members	1,039,313	164,045	951,920	2,155,279
Medicare Comprehensive Revenues	\$11,920,075,722	\$1,871,529,505	\$10,984,229,265	\$24,775,834,492
Comprehensive Total Revenues	\$16,582,892,255	\$18,073,472,442	\$115,622,560,855	\$150,278,925,553

*Excludes six firms included in two universes.

Background on SEER

Sixty health benefit organizations participated in this year's studies, and they collectively serve nearly 50 million beneficiaries of comprehensive health programs. These organizations are segmented into peer groups of Independent /Provider-Sponsored Plans, Larger Health Plans, Third Party Administrators, Blue Cross Blue Shield Plans and Medicare Plans.

Now completing our fourteenth year benchmarking health benefit organizations, the 2011 benchmarks (containing 2010 data) comprise the cumulative experience of approximately 514 health plan years. Summary results of the various universes may be found on our web site www.sherlockco.com.

The *Sherlock Expense Evaluation Report* is a compilation of the results of surveys completed by each participant, who receives a copy of the report in exchange for its participation and other consideration. The benefit of the report to participants is its application for internal cost management; this central motivation for their voluntary participation promotes the accuracy of

Appendix A. Medicare Advantage Benchmark Summary
 Medicare-Oriented Costs by Functional Area Cluster, 2009 Data
 Per Member Per Month

	25th PCTL	75th PCTL	Median	σ/ Mean
Sales and Marketing	\$9.52	\$32.56	\$16.10	63.4%
Provider & Med. Mgmt.	6.82	12.66	9.23	61.4%
Account & Mem. Admin.	11.37	28.16	14.91	52.2%
Corporate Services	6.53	17.64	11.30	65.8%
Total	\$38.03	\$91.55	\$44.71	55.2%

*Account & Membership Administration Includes Pharmacy and Mental Health

Appendix B. Medicare Advantage Benchmark Summary
 Medicare-Oriented Costs by Functional Area Cluster,
 as a Percent Premiums or Equivalents, 2009 Data
 Percent of Premium Equivalents

	25th PCTL	75th PCTL	Median	σ/ Mean
Sales and Marketing	2.1%	3.8%	3.1%	40.3%
Provider & Med. Mgmt.	1.4%	2.1%	1.6%	38.1%
Account & Mem. Admin.	2.4%	3.5%	2.8%	29.4%
Corporate Services	1.6%	2.6%	2.0%	44.9%
Total	7.5%	11.4%	9.0%	30.5%

*Account & Membership Administration Includes Pharmacy and Mental Health

participant reporting. Sherlock Company reinforces this through a series of checks and analyses intended to identify responses that are not in accordance with SEER definitions.